

Spring 3-1-1954

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James A. Taylor
Columbia, SC

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Recommended Citation

James A. Taylor, Federal Gift Tax Aspects of Release of Dower and Other Marital Rights Under Divorce or Separation Agreements, 6 S.C.L.R. 359. (1954).

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FEDERAL GIFT TAX ASPECTS OF RELEASE OF DOWER AND OTHER MARITAL RIGHTS UNDER DIVORCE OR SEPARATION AGREEMENTS

JAMES A. TAYLOR*

A payment, under a divorce or separation agreement, of money or property by one spouse to the other in consideration of the payee's release of all marital rights, exclusive of support rights, may or may not be subject to the Federal gift tax.

That part of a payment, or payments, which represents the reasonable value of support rights, constitutes a consideration in money or money's worth, and, to the extent a transfer does not exceed the reasonable value of the support rights, it is to be treated as made for such consideration, and is not subject to Federal gift tax.¹

This paper is confined to a consideration of the Federal gift tax liability, if any, on that part of a payment or payments made pursuant to a divorce or separation agreement, which exceeds the value of the support rights, and is made in consideration of a spouse's relinquishment of all other marital rights.

Sec. 1002 (Gift Tax) of the Internal Revenue Code, provides:

Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this chapter, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Sec. 812 (b) (Estate Tax) of the Code provides, in part:

. . . a relinquishment or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration "in money or money's worth".

A provision similar to Section 812 (b) does not appear under the gift tax provisions of the Code, nor is it incorporated in the gift tax regulations.

E. T. 19² (a ruling of the Treasury Department applicable to both Code provisions) provides:

*Attorney at Law, Columbia, South Carolina.

1. E.T. 19; 1945-2 CUM. BULL. 166.

2. *Ibid.*

Transfers of property pursuant to an agreement incident to divorce or legal separation are not made for an adequate and full consideration in money or money's worth to the extent that they are made in consideration of a relinquishment or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or other marital rights in the transferor's property or estate; to the extent that the transfers are made in satisfaction of support rights the transfers are held to be for an adequate and full consideration. The value of the relinquished support rights shall be ascertained on the basis of the facts and circumstances of each individual case.

The Treasury Department's position, expressed in the foregoing ruling, is bottomed on the correlation of the gift and estate taxes, and is based, in part, upon the decision in *Merrill v. Fahs*.³

In this case the Supreme Court, in holding that an ante-nuptial transfer was subject to the gift tax, found that Congress intended that the "consideration" or "relinquishment" provision in the estate tax law also applies to the gift tax, stating, in part, as follows:

The guiding light is what was said in *Estate of Sanford v. Commissioner*, (308 U. S. 39, 44): "The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together." The phrase on the meaning of which decision must largely turn—that is, transfers for other than "an adequate and full consideration in money or money's worth"—came into the gift tax by way of estate tax provisions.

In *Harris v. Commissioner*, *ante*, the rationale of the *Merrill* decision was held to be equally applicable to post-nuptial settlements.

Payments in accordance with a divorce settlement *which are in excess of the wife's value of support rights*, ordinarily are made to obtain a release of the wife's inheritance rights in the husband's estate, and, since a payment made in consideration of a relinquishment or promised relinquishment of marital rights, exclusive of support rights, would be taxed in the estate of the transferor, under the correlation argument, and under the general principle expressed in E. T. 19, *supra*, a similar payment in accordance with a divorce settlement would be taxed as a gift.

The case of *Commissioner v. Barnard Estate*⁴ appears to have been the first decision of an appellate court to sustain this conclu-

3. 324 U. S. 308, 33 A.F.T.R. 587 (1945).

4. 176 F. 2d 233 (2d Cir. 1949).

sion of the Treasury Department. In this case, Mrs. Barnard paid her husband \$50,000 under a written separation agreement, under the terms of which her husband relinquished any claims on her property. In addition, she promised orally to pay him an additional \$50,000 upon divorce, and did pay him that amount after the decree was obtained. The divorce decree incorporated the written contract but not the oral agreement. The U. S. Court of Appeals for the Second Circuit held that the entire \$100,000 paid was taxable as a gift. As the wife had no obligation to support her husband, the value of support rights were not involved. The Court rejected the argument that the ratification of the written agreement by a subsequent divorce decree brought the case within the rule of *Commissioner v. Converse*,⁵ a case which previously had been decided by the same Court.

In *Commissioner v. Converse* the parties had signed a separation agreement calling for monthly alimony payments. The husband appeared and denied that the agreement made was fair and just, alleged that a single payment would be for the best interests of the parties, and asked that the Court decree a lump-sum payment. After a trial, in which this was one of the issues litigated, the Court decreed such settlement. When this settlement was attacked as a gift, the Court held that any amount paid in accordance with the divorce decree represented a discharge of a money judgment, and the "payment of a liquidated debt created by the judgment, and the discharge thereby of the respondent's obligation to pay for that debt was an adequate consideration in money or money's worth for the transfer".

In the *Barnard* case, *supra*, the Court pointed out that the Barnards had made a settlement agreement, the payment of which was made according to the terms of the agreement before Mrs. Barnard had decided to bring divorce proceedings, whereas the settlement obligations in the *Converse* case arose directly from the decree in the divorce case, which created of its own force a judgment debt. The Court commented, further, that the *Converse* decision had been cited "beyond its scope".

The earlier Tax Court decisions would appear to have adopted the primary test of donative intent in its determination of divorce settlement gift tax questions.⁶

5. 163 F. 2d 133 (2d Cir. 1947).

6. Herbert Jones, 1 T.C. 1207 (1943); William Barclay Harding, 11 T.C. 1051 (1948); Edward B. McLean, 11 T.C. 543 (1948); Clarence B. Mitchell, 6 T.C. 159 (1946); Albert V. Moore, 10 T.C. 393 (1948); Edmund C. Converse, 5 T.C. 1014 (1945).

Accordingly, three possible rules were established in the earlier decisions:

- (1) *The Treasury Department-Barnard rule*: All amounts paid in divorce settlements *in excess of the value of the support rights* are subject to a gift tax insofar as they are paid for the release of inheritance and other marital rights.
- (2) *The Converse rule*: Any payment made in accordance with a divorce decree which is solely the result of a *contest in Court* will avoid a gift tax.
- (3) *The Tax Court rule*: Any payment made in accordance with a divorce decree which is the result of an "arms-length" bargaining will not give rise to a gift tax.

The confusion and conflict which is to be found in the earlier decisions of the Federal Courts seems now to have been settled by the decision of the Supreme Court in *Harris v. Commissioner of Internal Revenue*,⁷ and because of the importance of that decision, it is quoted at some length. In the *Harris* decision, a decision of the lower Court was reversed, and it was held that settlements incident to a divorce were not subject to the Federal gift tax.

In this case, the petitioner divorced her husband in Nevada in 1943. Both she and her husband had substantial property interests. They reached an understanding as regards the unscrambling of these interests, the settlement of all litigated claims to the separate properties, the assumption of obligations, and the transfer of properties.

The Court observed, and held:

If the parties had without more gone ahead and voluntarily unravelled their business interests on the basis of this compromise, there would be no question but what the gift tax would be payable. For there would have been a "promise or agreement" that affected a relinquishment of marital rights in property. It therefore would fall under the ban of the provision of the estate tax which by judicial construction had been incorporated into the gift tax statute.

But the parties did not simply undertake a voluntary contractual division of their property interests. They were faced with the fact that Nevada law not only authorized but instructed the divorce court to decree a just and equitable disposition of both the community and the separate property of the parties. The Agreement recited that it was executed in order to effect a

7. 340 U. S. 106, 39 A.F.T.R. 1002 (1950) (4 dissents).

settlement of the respective property rights of the parties "in the event a divorce should be decreed"; and it provided that the agreement should be submitted to the divorce court "for its approval". It went on to say, "It is of the essence of this agreement that the settlement herein provided for shall not become operative in any manner nor shall any of the recitals or covenants herein become binding upon either party unless a decree of absolute divorce between the parties shall be entered in the pending Nevada action".

If the agreements had stopped there and were in fact submitted to the court, it is clear that the gift tax would not be applicable. That arrangement would not be a "promise or agreement" in the statutory sense. It would be wholly conditional upon the entry of the decree: the divorce court might or might not accept the provisions of the arrangement as the measure of the respective obligations; it might indeed add to or subtract from them. The decree, not the arrangement submitted to the court, would fix the rights and obligations of the parties. That was the theory of *Commissioner of Internal Revenue v. Maresi*, 2 Cir., 156 F. (2) 929, and we think it sound.

Even the Commissioner concedes that the result would be correct in case the property settlement was litigated in the divorce action. That was what happened in *Commissioner of Internal Revenue v. Converse*, 2 Cir. 163 F. (2) 131, where the divorce court decreed a lump sum award in lieu of monthly payments provided by the separation agreement. Yet without the decree there would be no enforceable, existing agreement whether the settlement was litigated or unlitigated. Both require the approval of the court before an obligation arises. The happenstance that the divorce court might approve the entire settlement, or modify it in unsubstantial details, or work out material changes seems to us as unimportant. In each case it is the decree that creates the rights and the duties; and a decree is not a "promise or agreement" in any sense — popular or statutory.

If "the transfer" of marital rights in property is effected by the parties, it is pursuant to a "promise or agreement" in the meaning of the statute. If "the transfer" is effected by court decree, no "promise or agreement" of the parties is the operative fact. In no realistic sense is a court decree a "promise or agreement" between the parties to a litigation. If finer, more legalistic lines are to be drawn, Congress must do it.

The Court then went on to discuss the tax effect, or rather non-tax effect, of a further provision in the Harris agreement that "... the covenants in this agreement shall survive any decrees of divorce which may be entered." On this point it was held, in substance, that the gift tax statute is concerned with the source of rights and not with the manner in which they may be enforced at some distant time.

In *George G. McMurtry*,⁸ the significance and determinative effect of the incorporation of the settlement agreement in the decree and order of the Court is emphasized. The *McMurtry* case involved transfers in trust for the benefit of each of the husband's two former wives, and the decision was premised upon the findings of fact that each transfer was made in consideration of the wife's release of both her support rights and property rights arising out of the marital relationship, and the settlement agreements were negotiated, effected, and performed without reference to divorce decrees later rendered. It was held by the Tax Court in the *McMurtry* case, under the authority of the *Barnard* case, that the transfers were taxable as gifts to the extent they exceeded the values of the respective support rights of the wives.

The reversal, in part, of the Tax Court decision in *McMurtry* by the Court of Appeals of the First Circuit would not appear to have been based upon disagreement with the legal principle established in the Tax Court decision, but upon a material difference in finding of fact with reference to the transfers to one of the wives.

The Tax Court's decision in the *McMurtry* case is clearly distinguished from, and reconciled with, the decision of the Supreme Court in *Harris*, in the following excerpts from the *McMurtry* decision:

It is now clear from the Supreme Court's decision in the recent case of *Harris v. Commissioner*, 340 U. S. 106, that the rationale of the Merrill and Wemyss cases is also applicable to postnuptial settlements, where it can be said that the transfer of property was effected by the promise or agreement of the spouses. In such an instance the transfer of property is taxable as a gift to the extent it was made in consideration of the release of marital property rights. Where the postnuptial settlement is followed by the entry of a divorce decree, we have the preliminary question whether the transfer of property was founded upon the promise or agreement or upon the divorce decree. If it be determined that the divorce decree effected the transfer of

8. 16 T.C. 168 (1951), *rev'd in part*, 203 F. 2d 659 (1st Cir. 1953).

property between the parties, then there is no promise or agreement concerning marital rights in property to which the principles of the Merrill and Wemyss cases are applicable, and any transfers of property are free from gift tax liability.

We are convinced that the facts surrounding the transfer in trust to Mabel Post McMurtry and the transfers in trust to Louise Hunt McMurtry are so entirely different from the facts considered to be decisive by the Supreme Court in the *Harris* case that our determination is not governed by that decision. The holding of the Supreme Court in *Harris v. Commissioner, supra*, that the transfer of property to the husband was not taxable as a gift was hinged on the fact that the effective operation of the property settlement was by its terms subject to a condition precedent, that there be an entry of a divorce decree. In the present case it is apparent from the terms of the postnuptial agreement between petitioner and Mabel Post McMurtry that its effectiveness was in no way dependent on the entry of a divorce decree. Furthermore, when she obtained a divorce, the decree failed to provide for alimony and made no mention of the separation agreement. It follows that the transfer in trust for her benefit was solely founded upon and made effective by the promise or agreement of the parties. Thus we hold that to the extent the transfer was in consideration for the release of her marital property rights, it is taxable as a gift under section 1002 of the Code.

The *Harris* case is distinguished further in *Commissioner of Internal Revenue v. Tillie Blum*,⁹ *Hardenberg v. Commissioner*,¹⁰ and *Paul Rosenthal*.¹¹ In the latter case, although the separation agreement was made a part of a later divorce decree, the effectiveness of the agreement was not made dependent upon the decree, but, on the contrary, the agreement left either party free to institute or not institute divorce proceedings.

Under the *Harris* decision, and the *McMurtry* decision, which explains and distinguishes the *Harris* decision, and provided:

- (1) The terms of settlement are arrived at through arms-length negotiations between the parties;
- (2) No part of the payments made under the terms of the settlement agreement is made with donative intent;

9. 187 F. 2d 180 (7th Cir. 1951).

10. 198 F. 2d 63 (8th Cir. 1952).

11. 17 T.C. 1047 (1951).

- (3) The agreement recites that it is executed in order to effect a settlement of the respective property rights of the parties in the event a divorce should be decreed, and is made contingent upon the decree;
- (4) The operation of the settlement agreement is made expressly subject to the condition precedent that the terms of the agreement be considered, approved, and decreed by the court;
- (5) The consideration, approval, and adoption of the settlement agreement by the court is expressly stated in the decree and order of the court,

it would now appear that payments made under the terms of a settlement agreement, and in strict accord with the court decree, will not be subject to the Federal gift tax.

Assuming a Federal gift tax may not result, under the circumstances discussed, the interesting, and important, collateral question may arise: whether the transferee spouse, under the broad provisions of Section 22 (a) of the Internal Revenue Code, which defines gross income for the purpose of the Federal income tax, may not be subject to Federal income tax upon gift tax-free payments received.

Up to the present time, it does not appear that the Treasury Department has adopted this contention in any case in which a transfer was held to be gift-tax free under the rule established in the *Harris* and related cases.